# "AN APPRAISAL OF HARMFUL TAX COMPETITION"

**VIVEK SHUKLA[1]**
**UNIVERSITY OF LUCKNOW**

**DR. SOMESH KUMAR SHUKLA[2]**
**UNIVERSITY OF LUCKNOW**

**Abstract:**

*The process of globalisation has led to increased competition among businesses in the global market place. Multinational enterprises (MNEs) are increasingly developing global strategies and their links with any one country are becoming more tenuous. In addition, technological innovation has affected the way in which MNEs are managed and made the physical location of management and other service activities much less important to the MNE. International financial markets continue to expand, a development that facilitates global welfare-enhancing cross-border capital flows. This process has improved welfare and living standards around the world by creating more efficient allocation and utilization of resources.[3]*

*Globalization and technology have not only leaded to tremendous economic benefits for some but have also created many serious negative side effects for others. National boundaries are becoming less important. Multinational Enterprises ("MNEs") and wealthy individuals are more easily able to avoid taxation using tax havens.*

***Keywords:*** *Base erosion and profit shifting, Organization for economic cooperation and development, Multinational companies, Low tax jurisdictions.*

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**LIST OF ABBREVIATIONS**

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| BEPS | Base Erosion and Profit Shifting |
| B2C | Business To Consumer |
| CFC | Controlled Foreign Company |
| DTAA | Double Taxation Avoidance Agreements |
| DTC | Direct Tax Code |
| DTTs | Double Tax Treaties |
| IIAs | International Investment Agreements |
| IMF | International Monetary Fund |
| IT | Income Tax |
| MLE | Multi Location Enterprises |
| MNC | Multi-National Companies |
| MNEs | Multi National Enterprises |
| OECD | Organisation for Economic Co-operation and Development |
| PE | Permanent Establishment |
| SAAR | Specific Anti-Avoidance Rules |
| SDTs | Specified Domestic Transactions |
| TP | Transfer Pricing |
| TPR | Transfer Pricing Regulations |

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[1] Research scholar, University of Lucknow, R/O Ashiana colony, Lucknow, vivekshuklahs@gmail.com, +918765922837, ORCID 0000-0003-4624-2702.
[2] Professor and Dean of Commerce Department, University of Lucknow, R/O Jankipuram Lucknow, shukla_sk@lkouniv.ac.in, +919450378945.

[3]Organisation for Economic Co-operation and Development (OECD) Report, *"Harmful TaxCompetition: An Emerging Global Issue",* 1988.

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| UK | United Kingdom |
| UN | United Nations |
| US | United States |
| USA | United States of America |
| VAT | Value Added Tax |

**1.1 Introduction:**

Globalization has had its positive effects on the development of tax systems and has encouraged countries to engage in base broadening and rate reducing tax reforms. However, it has also created an environment in which tax havens thrive and in which governments may be induced to adopt harmful preferential tax regimes to attract mobile activities. Harmful Tax Competition, in the form of harmful tax practices, can severely disfigure trade and investment patterns, wash national tax bases and shift part of the tax burden onto less mobile tax bases, such as labour and consumption, thus adversely affecting employment and undermining the fairness of tax structures. Governments often promote policies to curb the supposed power of monopolies, monophony and cartels. Sometimes, such policies are pursued because there is a technical understanding of the welfare losses that can arise from anti-competitive behaviour. But underlying such intervention there is often a general concern about the power that can be wielded by firms or groups of firms that subvert competition.

In May 1996 Ministers called upon the OECD to develop measures to eliminate the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases, and report back in 1998.In response to the Ministers' request, the OECD's Committee on Fiscal Affairs launched its project on harmful tax competition. The results of this project are available, which address harmful tax practices in the form of tax havens and harmful preferential tax regimes in OECD member countries and non-member countries and their dependencies. It focuses mainly on geographically mobile activities like financial and other service activities. The Report defines the factors to be used in identifying harmful tax practices and goes on to make19 wide-ranging Recommendations to counteract such practices[4].

Addison observes that tax havens only cooperate with investigations when they are presented with evidence of wrongdoing. Importantly, without a tax haven's cooperation, he suggests that this evidence is usually unavailable and nearly impossible to obtain[5].Earlier, tax policies were specifically designed to address the domestic, social and economic concerns of the country and they had domestic effects principally. However, the accelerating pace of globalization of trade and commerce has fundamentally changed the idea and has gone a long way in reformation of the fiscal system world over. The reformations focus on broadening of the income base and rate reductions thus reducing tax induced distortions. However, it comes with its share of limitations. Globalization has had the effect of opening up new ways through potential distortions in the patterns of trade and investment by which base can be eroded and individuals can minimize and avoid their tax liabilities, thus hampering the achievement of redistributive role of the economy. Moreover, globalization and the increased mobility of capital has also promoted the development of capital and financial markets and has encouraged countries to reduce tax barriers to capital flows and to modernize their tax systems to reflect these developments[6]. Countries are bound by many other financing liabilities of funding public utilities like education system of the country, defence expenses, infrastructure development, etc. Tax havens that impose nominal or zero tax in their territories come as a blessing in disguise for investors who want to evade tax liability in their domestic countries by investing in those tax havens.

The committee acknowledges that the countries are free to decide their rates of taxation depending upon the domestic needs as long as they abide by the internationally accepted standards. For example, a particular country may lower the rates and broaden the base to promote greater neutrality. Harmful effects may also crop up due to structural mismatches between the taxation regimes of two countries which may be exploited to the detriment of either of the two countries or both the countries by taxpayers. Such issues can be dealt with by either bilateral or multilateral measures. Tax havens and preferential taxation regimes can essentially cause harm by the following activities:

[4] *Harmful Tax Competition - An Emerging Global Issue, Foreword,* Organization for Economic Cooperation and Development(OECD) Report.

[5] Timothy Addison, *Shooting Blanks: The War on Tax Havens*, 2009, 16, *Indiana Journal of Global Legal Studies,* p.718.

[6] Retrieved from http : // www. oecd. org / tax / transparency / 44430243. pdf, (last accessed on 14 April, 2014).

I. Distortion of financial and indirect real investment flows;
II. Undermining the integrity and fairness of tax structure in domestic country;
III. Discouraging compliance by tax payers;
IV. Causing undesired shifts of part of tax burden to lesser mobile tax bases like labour, property and consumption; and
V. Increasing administrative costs and compliance burden on authorities and tax payers.

The report clearly states that any practice consisting of all these elements shall be considered to be harmful and in cases where a few of these elements are present, the degree of harm can be measured by balancing of several factors. The residence country can up to a large extent protect itself from the negative impact of such practices by modifying its own tax rules as a targeted response. Moreover the report points out that in regimes where negative impact on the economy cannot be quantified can prove to be harmful because of preclusion of data required for such measurement. Globalization although continues to have many positive impacts on the economies world over but nevertheless, the economies should take active measures to reduce tax distortions caused worldwide which in turn shall help in full realization of financial and capital flows.
Tax competition due to the following:

i) Foreign direct investments;

ii) Portfolio investments, highly mobile financial capital, essential for financing the local companies and strengthening the local financial markets;

iii) Internal financial flows within the multinational companies that can be lured to own jurisdictions by attracting those corporate units used for international transfer of profits;

iv) Cross border shoppers, especially for those products subject to excise taxes, when there are significant differences in the level of those excises;

v) High skilled labour, characterized by high mobility.[7]

**1.2 Research Objectives**

a) To study the recommendations and guidelines given by the OECD for dealing with Harmful Tax Competition.
b) To study about the need for emergence of Tax Information Exchange Agreements, i.e., harmful tax competition, and factors laid down by the Organization for Economic Cooperation and Development (OECD) for determining regimes as harmful preferential tax regimes.

**1.3 Benefits of Tax Competition**

Tax competition is been used by the governments to make their tax rates effective by lower down their tax rates to attract capital and business activity to their country. This is believed to have a two-stage effect on the world's tax systems:

First, some pioneer countries will reduce their tax rates, or otherwise alter their tax systems to offer low effective tax rates (countries that lower their tax rates to very low or zero levels are commonly known as 'tax havens').

Second, other countries could lower their own taxes in response to perceived or actual losses from this competition.[8]
This tax competition has grown as part of the general increase in international trade and investment, and is part of the process of globalisation. Tax competition brings great benefits, to all society and not just to those who directly take advantage of it. But the greatest benefits go to those countries that work in harmony with global free markets, not to those protectionists who try to erect barriers against the tide. The reduction in barriers to

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[7] *Ibid*
[8] Richard Teather, "The Benefits of Tax Competition", *The Institute of Economic Affairs,* available athttp : // www. iea .org. uk / sites / default / files / publications / files / upldbook 303 pdf,pdf.

international trade, investment and relocation in the 1980s not only improved the operation of the global free market but also allowed more people to take advantage of low tax rates in other countries. It therefore made tax competition more effective, and helped prompt much-needed tax reform.

There are three main areas where tax competition and tax havens in general, affect the economy: they can have an impact on markets, on companies and also on governments. Some of the benefits are here as under:

i) Tax competition acts as a check on governments' ability to raise taxes; it ensures that governments have more limited funds and thus provides incentives for governments to spend more wisely.

ii) By preventing taxes becoming too high, tax competition boosts economic welfare, productive investment and employment. Low-tax jurisdictions also make global capital markets more efficient.

iii) These benefits, of more efficient government spending and more productive capital investment by business, flow to everyone, not just to those who benefit directly from low-tax jurisdictions.[9]

iv) Lower tax rates mean greater wealth – If tax competition can keep tax rates down, particularly those on highly mobile investment capital, and so increase savings, then it will boost overall wealth.

v) Tax competition helps in making efficient global capital markets.

vi) If global capital markets are made efficient then simultaneously business becomes more efficient.

Tax competition also affects the behaviour of government. It acts as a restraint on government ability to raise taxes and provides incentives for governments to spend more wisely.

**1.4 Key Factors in Identifying Tax Havens**

The Report focuses on identifying the factors that enable tax havens and harmful preferential tax regimes in OECD Member and non-member countries to attract highly mobile activities, such as financial and other service activities. Further the Report provides practical guidelines to assist governments in identifying tax havens and in distinguishing between acceptable and harmful preferential tax regimes.

i) **No or nominal taxes:** No or nominal taxation on the relevant income is the starting point to classify a jurisdiction as a tax haven.
ii) **Lack of effective exchange of information:** tax haven typically have in place laws or administrative practices under which business and individuals can benefit from strict secrecy rules and other safeguards against inspection by tax officials thereby preventing the exchange information on taxpayers benefiting from the low tax jurisdiction.
iii) **Lack of Transparency**: Lack of transparency either through legislative or administrative or any legal provision plays an important factor in identifying a tax haven. Non transparent activities or unwillingness to share tax information facilitates illegal activities like money laundering and tax evasion. These jurisdictions do not allow tax administrators access to bank information for the critical purpose of detecting and preventing tax avoidance and saving base erosion.
iv) **No substantial activities:** If despite no substantial activities being carried out, tax holidays are allowed suggests that a jurisdiction is attempting to attract investment or transactions that are totally tax driven. For example, certain services provided by "paper companies" may readily be regarded as lacking substance. Many other factors like a strong business infrastructure and easy regulatory frameworks contribute even more to a tax haven's success.

**1.5 Assessment of Economic Effects of Harmful Preferential Tax Regimes**

To constitute a preferential tax regime as harmful, it is important to pose a few questions as to the effects that will entail in the home country of the taxpayer. They are

*I. Does the tax regime switch activity from one Nation to the Nation providing the preferential tax*

[9] *Ibid*

*regime, rather than generate significant new activity?*
Answering this question involves an analysis of a combination of factors like the domestic taxation atmosphere and the preferential tax regime of the host country. Sometimes the atmosphere is such that it tends to drive out the investment independent of the tax policies pursued in other countries.

II. *Is the level of activities in the host country at par with the amount of investment or income?*
An analysis of whether the investment undertaken and the return generated is commensurate with one another goes a long way in answering this question. If they are non-commensurate implies that the preferential tax regime is harmful.

III. *Is the preferential tax regime the primary motivation for the location of an activity?*

If the primary motive of pursuing an activity is the preferential tax regime, it clearly indicates that the regime in question is potentially harmful. Practically it is not an easy task for the authorities to determine the motive behind investments made in these preferred destinations because many other actors like presence of raw material, regulatory framework and administrative ease also play a vital role.

**1.6 Guidelines for dealing with Harmful Tax Practices**

***1.6.1 Recommendations concerning domestic legislations and practices***

I. Countries that do not have Controlled Foreign Corporations (CFC) rules should consider adopting them in their domestic tax regimes and tailor them in such a way that it helps in curbing harmful tax practices;
II. Those countries which do not have rules concerning reporting of international transactions and foreign operations of resident taxpayers consider adopting such rules and that countries be obliged to exchange information obtained under these rules;
III. Applying Transfer Pricing Rules in such a way that would enhance matters in tax cooperation;
IV. Jurisdictions should reexamine their laws, guidelines and practices which govern access to banking information with a view to removing impediments to the access to such information by tax authorities.

***1.6.2 Recommendations concerning tax treaties***

I. Countries should undertake programs to intensify exchange of relevant information concerning transactions in tax havens and preferential tax regimes constituting harmful tax competition;
II. Clarification of the status of local anti-abuse rules and doctrines in tax treaties that the Commentary on the Model Tax Convention be clarified to eliminate any uncertainty or ambiguity regarding the affinity of domestic anti-abuse measures with the Model Tax Convention;
III. Countries may consider terminating their tax conventions with tax havens and consider not entering into tax treaties with such countries in future;
IV. Countries should consider undertaking mutually coordinated enforcement programs such as simultaneous examinations, specific exchange of information projects or joint training activities in relation to income or taxpayers benefiting from practices constituting harmful tax competition.

***1.6.3 Recommendations to intensify International Cooperation in response to Harmful Tax Competition***

I. Member countries should endorse the Guidelines on harmful preferential tax regimes set out and establish a Forum to implement the Guidelines laid down;
II. A list of tax havens should be prepared as per the guidelines mentioned in the report and any transaction taking place with those regimes should be tailored accordingly;
III. Countries which have particular political, economic or other links with tax havens ensure that these links do not contribute to harmful tax competition and, in particular, ensure that the links that they have with these tax havens are not used in a way that increases or promotes harmful tax competition;

Countries should develop and actively promote Principles of Good Tax Administration;

***1.6.4 Guidelines for dealing with Harmful Preferential Tax Regimes in Member Countries***

The first recommendation in recommendations to intensify international co-operation in response to harmful tax competition regarding establishing a Forum to implement the Guidelines and other Recommendations in the report, it sets out the following guidelines:

I. As defined in Section III of Chapter 2 of the Report, To refrain from adopting new measures, or extending the scope of, or strengthening existing measures, in the form of legislative provisions or administrative practices related to taxation, that initiate harmful tax practices.;
II. To review their existing measures for the purpose of identifying those measures, in the form of legislative provisions or administrative practices related to taxation, that constitute harmful tax practices as defined in Section III of Chapter 2 of the Report. These measures will be reported to the Forum on Harmful Tax Practices and will be included in a list within 2 years from the date on which these Guidelines are approved by the OECD Council;
III. To remove, with in 5 years commencing from the date on which the Guidelines are approved by the OECD Council, the harmful features of their preferential tax regimes identified in the list referred to in paragraph 2. However, in respect of taxpayers who are benefiting from such regimes on 31 December 2000, the benefits that they derive will be removed at the latest on the 31 December 2005. This will ensure that such particular tax benefits have been entirely removed after that date;
IV. Each representative nation which has reason to believe that an existing measure not already included in the list referred to in paragraph 2, or a proposed or new measure of itself, constitutes a measure in the form of legislative provision or administrative practice related to taxation, that might constitute a harmful tax practice in light of the factors identified in Section III of Chapter 2 of the Report, may appeal that the action be examined by the representative nations, through the Forum on Harmful Tax Practices, for purposes of the application of paragraph 1 or for inclusion in the list referred to in paragraph 2. The Forum may issue a non-binding opinion on that question;
V. To coordinate, through the Forum, their national and treaty responses to harmful tax practices adopted by other countries; and
VI. To use the Forum to encourage actively non-member countries to associate themselves with these Guidelines.

**1.7 Conclusion and Analysis of the Recommendations**

Therefore, tax competition is just one slice of this competition among countries, but it is increasingly important because of the growing mobility of capital and labour. Workers and people with money to invest want to obtain the best after-tax reward (or rate of return), and their search for profitable opportunities is not limited by national borders. That is why, the investors and workers tend to leave or avoid nations with punitive tax burdens and onerous tax codes. The most innovative recommendation falls in the area of intensifying international cooperation where the guidelines encourage the member and non-member countries to work together in the direction of curbing harmful tax competition. The guidelines talk about the three R's:

I. To 'Refrain' from strengthening existing laws or adopting new laws that promote harmful tax practices in any way;
II. To 'Review' the existing measures of administrative and legislative nature and identifying those constituting harmful tax activities and be reported to the forum; and

To 'Remove' such activities from the regime as constitute harmful within a period of five years from the date of approval of the OECD report.